United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

77-7183

To be argued by
CLARENCE FRIED

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & CO.,

Defendant-Appellee.

BRIEF OF PLAINTIFF-APPELLANT SECURITIES INVESTOR PROTECTION CORPORATION

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FOR THE SECOND CIRCUIT

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & CO.,

Defendant-Appellee.

BRIEF OF PLAINTIFF-APPELLANT SECURITIES INVESTOR PROTECTION CORPORATION

Statement

Securities Investor Protection Corporation ("SIPC") appeals from an order and judgment (A 103a),* entered on March 15, 1977 in the United States District Court for the Southern District of New York, whereby the Honorable Inzer B. Wyatt dismissed the action. The order and judgment followed Judge Wyatt's decision of March 1, 1977, which is reported at 428 F.Supp. 483 and appears in the Joint Appendix at 391a.

SIPC, a non-profit membership corporation whose membership consists of virtually all the registered broker-dealers and national securities exchange members in this

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* Numbers in parentheses prefaced by "A" refer to the Joint Appendix.

country, was created by and organized under the Securities Investor Protection Act of 1970 ("SIPA") to, *inter alia*, maintain a fund for the satisfaction of the claims of the customers of defunct broker-dealers. SIPC is joined in this appeal by its co-plaintiff, Edward S. Redington, the Trustee for the liquidation of the business of Weis Securities, Inc. ("the Trustee"), who is submitting a separate appellate brief.

In the complaint, plaintiffs sought to recover the damages suffered as a direct result of the failure of defendant Touche Ross & Co. ("Touche Ross"), a firm of certified public accountants, to properly perform certain accounting services required by Section 17 of the Securities Exchange Act of 1934 ("the 1934 Act") for Weis Securities, Inc. ("Weis"), a brokerage firm and a SIPC member which is being liquidated under SIPA. SIPC asserted claims, under Section 17 and under the common law, both in its own right and as the subrogee of the customers of Weis whose claims were satisfied through the depletion of the SIPC fund.

Touche Ross responded to the complaint by moving for its dismissal, principally on the ground that the Section 17 claims fail to state a claim for which relief can be granted. Holding that no private right of action may be implied under Section 17, the District Court dismissed SIPC's first four claims and the Trustee's first claim for failure to state a claim for which relief can be granted. SIPC's other four claims and the Trustee's other five claims, all of which were based on common law principles, were dismissed for lack of jurisdiction over the subject matter.

Issues Presented

1. Did the District Court ignore the purpose for which SIPC was created and the manner in which SIPC operates, and thus erroneously conclude that a right of action may not be implied under Section 17 of the 1934 Act in favor of SIPC?

2. Did the District Court ignore that Section 17 of the 1934 Act was devised for the protection of the customers of broker-dealers, and thus erroneously conclude that a right of action may not be implied under that Section in favor of SIPC as subrogee of Weis' customers?

Nature of Case

This action results from the audit of Weis as at May 26, 1972 ("the 1972 audit") by Touche Ross. In conducting the 1972 audit, Touche Ross prepared and certified earnings statements, balance sheets and other financial documents which in fact constituted a materially false and misleading statement of Weis' financial affairs. These reports were required to be filed with the appropriate regulatory authorities pursuant to Section 17 of the 1934 Act and the rules and regulations thereunder, and were intended for the benefit of, *inter alia,* Weis' customers, SIPC, the Securities Exchange Commission ("the SEC"), and the New York Stock Exchange ("the Exchange"), the organization designated by SIPC to examine Weis for compliance with the applicable financial responsibility rules and to alert SIPC to Weis' financial difficulty.

The true financial condition of Weis was such that, despite the ostensibly satisfactory condition shown in the documents certified by Touche Ross during the 1972 audit, within a year the SEC commenced an action in the United States District Court for the Southern District of New York for injunctive relief to prevent five of Weis' officers ("the Weis Five"), who had perpetrated a three million dollar fraud on the public, from conducting the business of Weis in violation of the 1934 Act and the rules and regulations promulgated thereunder (A 167a), and SIPC applied to the same Court for a decree adjudicating that Weis' customers were in need of the protection afforded to them by Congress in SIPA.*

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* The Weis Five were subsequently indicted (A 185a) and convicted.

On May 30, 1973, the decree sought by SIPC was granted, the liquidation of Weis was ordered, and the Trustee was appointed to liquidate the business of Weis. Consequently, SIPC was required by SIPA to provide, and did provide, to the Trustee at least fourteen million dollars for the payment of claims submitted by customers and certain other creditors of Weis and for some administrative expenses of the liquidation.

As previously noted, the vehicles for Weis' deception were the Section 17 reports prepared and certified by Touche Ross. These reports play a role of paramount importance in the legislative scheme devised by Congress in the 1934 Act and SIPA, and effectuated by the regulatory authorities, for the protection of the customers of broker-dealers and to guard against the depletion of the SIPC fund. SIPC itself has no authority to examine its members such as Weis. Rather, it relies completely on the self-regulatory organization to which the SIPC member belongs (in the case of Weis, the Exchange) to examine the broker-dealer for compliance with the applicable financial responsibility rules and to alert SIPC to the broker-dealer's financial difficulty. The self-regulatory organization, in turn, relies on the Section 17 reports prepared by the broker-dealers' accountant (here, Touche Ross) to determine whether the broker-dealer is in compliance and financially sound. And, of course, the broker-dealers' customers (SIPC's subrogors) rely on the efficacy of the statutory and regulatory system created for their protection. Simply put, the protection of the customer and of the SIPC fund can only be as effective as the Section 17 reports prepared and certified by the accountant are accurate.

Thus, Touche Ross bore a heavy responsibility indeed in preparing and certifying Weis' Section 17 reports. By shirking that responsibility, Touche Ross lulled Weis' customers, SIPC, the SEC and the Exchange into believing or assuming that Weis was in sound financial condition and in compliance with the applicable financial re-

sponsibility rules as of the date of the 1972 audit. As a result of the deception thereby perpetrated by Touche Ross, the possibility of timely remedial action to avert a forced liquidation of Weis under SIPA was obviated. Accordingly, by the time Weis' true financial condition was discovered, the only remedial action available was just such a forced liquidation. Since Weis' assets and the property it was holding in trust for its customers were not sufficient to satisfy the claims of its customers, creditors, lenders and shareholders, the price for Touche Ross' deception was ultimately paid by SIPC. In short, the depletion of the SIPC fund was proximately caused by Touche Ross' misfeasance and nonfeasance.

SIPC commenced this action to recover from Touche Ross the fourteen million dollars it has lost as a direct result of the latter's breach of the duties it owed to SIPC and to Weis' customers (SIPC's subrogors) under Section 17 and the rules and regulations thereunder. Federal jurisdiction was predicated, *inter alia,* upon Section 27 of the 1934 Act, which grants to the district courts exclusive jurisdiction of violations of that Act or the rules and regulations thereunder.* SIPC asserted four claims in its own right and four as the subrogee of Weis' customers. Two of SIPC's direct claims and two of its subrogation claims were predicated upon Section 17; the

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* Jurisdiction was also predicated upon Sections 1331 and 1332 of the United States Judicial Code and upon the principles of pendent jurisdiction. The District Court concluded that jurisdiction under Sections 1331 and 1332 was lacking, and the issues of federal question and diversity jurisdiction are not raised on this appeal. The District Court's conclusion that there was no pendent jurisdiction was based on its dismissal of the Section 17 claims. Of course, a reversal of the dismissal of those claims would dictate the recognition of pendent jurisdiction over the common law claims because (a) the federal claims have "substance sufficient to confer subject matter jurisdiction" on the federal courts, and (b) the state claims arise from the "same nucleus of operative facts" as the federal claims. *United Mine Workers of America* v. *Gibbs,* 383 U.S. 715 (1966).

remaining four claims were based upon common law principles.

The complaint was met at the pleading stage by Touche Ross' motion to dismiss (A 127a), before any meaningful discovery had taken place and, thus, prior to the elicitation of facts which are vital to the determination of the questions of duty which are germane to SIPC's claims. The District Court granted the motion, concluding that "Section 17 was designed to supply administrative guidance in the bookkeeping area and not to create any rights in anybody" (A 400a). In so doing, the District Court failed to recognize a right of action under Section 17 in the extremely narrow and rare factual context in which such a recognition is sought and would be appropriate —where an auditor actually facilitates the collapse of a brokerage firm and thereby causes damage to SIPC.

Statement of Facts

As just noted, the action was dismissed at the pleading stage before any meaningful discovery had taken place.* Accordingly, this Statement of Facts is, for the most part, a summary of the allegations contained in the complaint.** Of course, for the purposes of this appeal from an order dismissing the action on the pleadings, the allegations of the complaint must be accepted as true (*Build of Buffalo, Inc.* v. *Sedita,* 441 F.2d 284, 287 (2nd Cir.

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* Prior to the dismissal of the action, Touche Ross partially answered a limited set of preliminary interrogatories served upon it by plaintiffs (A 92a). No disclosure has been obtained by any of the parties in a parallel and virtually dormant action instituted by SIPC and the Trustee against Touche Ross in New York State Supreme Court, wherein naturally no Section 17 claims are asserted.

** Paragraph designations in parentheses refer to the complaint, which appears in the Joint Appendix at 5a.

1971)) and should be considered favorably to the pleader (*Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974)).

The factual heart of the case is essentially pleaded under the heading "Common Allegations" (¶¶ 8-31) which are repleaded and incorporated by reference in each of the eight claims subsequently pleaded by SIPC (¶¶ 50-85).

A. The Weis-Touche Ross Relationship

Touche Ross was hardly a stranger to the operations, personnel, and financial affairs of Weis when it performed the 1972 audit. From about 1969 until May 1973, Touche Ross had served as Weis' independent certified public accounting firm (¶ 7). In that capacity, Touche Ross purported to audit the affairs of Weis on an annual basis as required by Section 17 of the 1934 Act, the applicable standards of the accounting profession, and the audit regulations of the SEC and the Exchange (¶ 17).

B. Weis' Concealment of its True Financial Condition

Certain of Weis' officers successfully conspired to conceal substantial operating losses during fiscal year 1972 by falsifying the financial reports required to be filed with the regulatory authorities pursuant to Section 17 (¶ 10). The devices employed and the transactions involved in the fraud perpetrated by the Weis Five on the public are alleged in considerable detail (¶¶ 10, 12 & 29). For example, Weis' pre-tax earnings were misstated as in the range of $1,700,000 where, in fact, Weis had suffered losses in excess of $1,500,000 (¶ 10). Thus, at the very least, this action involves Touche Ross' certification of a 3.2 million dollar fraud.

C. Touche Ross' Public Duty and Undertaking

The regulatory and statutory requirements were known to Touche Ross when it was performing its audit of Weis' financial affairs for fiscal year 1972 (¶ 16).

The Exchange, of which Weis was a member, had been designated by SIPC as Weis' examining authority for the purpose of determining Weis' compliance with applicable financial responsibility rules pursuant to Section 6 of the 1934 Act (¶ 8). The purpose, in part, of that designation was to assure Weis' maintenance of minimum financial prerequisites to doing business as a broker-dealer (¶ 8).

Weis' financial reports for fiscal year 1972 were required to be filed with the regulatory authorities pursuant to Section 17 (¶ 10). Touche Ross held itself out to SIPC, the Exchange, the SEC, and the general public as being qualified, among other things, to prepare reports and opinions required by Section 17 and the rules and regulations thereunder, by reason of its familiarity with the accounting and auditing practices and standards required by the SEC and the Exchange (¶ 16). Touche Ross undertook to audit Weis' affairs and issue opinions and prepare reports on its financial statements in accordance with Section 17, other applicable professional standards, and the audit regulations of the SEC and the Exchange (¶¶ 17, 19).

Touche Ross knew or should have known that its undertaking to perform the 1972 audit was not merely a matter of private contract with Weis, but was required by the Exchange, pursuant to its duty under Section 6 of the 1934 Act, to regulate Weis' conduct of its business and to supervise its financial condition for the benefit of the investing public (¶ 20). Moreover, Touche Ross knew or should have known that its examination of and report on Weis' financial condition were required by Section 17 of the 1934 Act and the rules and regulations thereunder, and were intended for the benefit and reliance of

persons other than Weis, including SIPC, the Exchange, the SEC, and Weis' customers (¶¶ 21, 22, 26 & 27).*

D. Touche Ross' Certification

Touche Ross, with full awareness of its statutory and professional duties, certified as correct and complete the grossly fraudulent financial statements of Weis (¶¶ 12, 23, 24). Specifically, based on its audit of Weis for fiscal year 1972, Touche Ross (a) prepared and certified Weis' answers to the financial questionnaire required by the Exchange ("Answers to Exchange Questionnaire"), (b) prepared and certified Weis' financial statements, and (c) issued four opinion letters attesting to the accuracy of the financial statements and the proper discharge of Touche Ross' responsibilities as auditor (¶¶ 23, 24).**

In the letter pertaining to the Answers to Exchange Questionnarie (A 41a), Touche Ross represented, among other things, that its audit of Weis conformed to applicable professional standards "including the audit procedures prescribed by the New York Stock Exchange and

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* As demonstrated by an affidavit submitted to the District Court (A 316a), at the time it conducted the audit of Weis, Touche Ross was well aware of its obligation to SIPC and of SIPC's structure, functions and objectives in that, among other things, before and during the Weis audit Touche Ross was involved in two SIPA liquidation proceedings in the Southern District of New York, namely, the liquidation of J. R. Radin & Co., Inc. and Kenneth Bove & Co. Both of those proceedings were commenced well before the 1972 Weis audit. Numerous Touche Ross personnel who worked on the Radin or Bove proceedings also were engaged in the Weis audit. In addition, Touche Ross served as accountant to the trustee in three other SIPA liquidation proceedings both prior to and during the 1972 Weis audit.

** The opinion letters, financial statement and Answers to Exchange Questionnaire are annexed to the complaint as Exhibits A, B, C, and D and appear in the Joint Appendix at 32a-91a.

the Securities and Exchange Commission", and that the answers to the questionnaire were "in the form prescribed by the [Exchange] and the [SEC]" (¶ 24).

E. Touche Ross' Misfeasance and Nonfeasance

In Paragraph 23 of the complaint, it is alleged that:

> "Touche Ross breached and failed to perform its agreement and obligation to render auditing and accounting services with respect to Weis in a thorough, proper, skillful and diligent manner *and performed said services in a negligent, reckless, careless, unskilled and grossly negligent manner. . . .*" (emphasis added).

The latter allegation of both misfeasance and nonfeasance is followed by seven specifications, including allegations that Touche Ross rendered false opinion letters and "falsely certified" that its audit conformed to applicable professional standards "and the audit regulations of the Exchange and the SEC". Further specifications of Touche Ross' misfeasance and nonfeasance are set forth in considerable detail in paragraph 29 of the complaint (two full pages).

F. Touche Ross' Knowledge of Third Party Reliance

The reports of Weis' financial condition at fiscal year-end 1972, required to be filed with the regulatory authorities pursuant to Section 17, were intended for and were directly or indirectly submitted to (among others) SIPC, the Exchange, the SEC, and Weis' customers (¶¶ 10, 21). Touche Ross knew or should have known that such entities and persons would rely on the result of its audit (¶¶ 20-22). Specifically, Touche Ross "knew, should have known and intended" that these entities and persons would rely on its opinion letters, the financial statements, and the Answers to Exchange Questionnaire (¶¶ 26, 27). Touche Ross knew that, in discharging their respective public

responsibilities, SIPC, the SEC and the Exchange would rely on its audit "in determining whether Weis was in compliance with the applicable financial responsibility rules, and in determining whether Weis was in financial difficulty" (¶ 26). And with respect to Weis' customers and other creditors, Touche Ross knew that such persons would rely on the audit "in making decisions whether to commence or continue their respective relations with Weis" (¶ 27).

G. Touche Ross' Breach of its Duty of Disclosure

Had Touche Ross conducted its audit in the manner which it represented in its opinion letter, certifications and the like it would have discovered the mammoth fraud perpetrated by Weis' officers and would have had a corresponding legal obligation "to report such discoveries in the 1972 Opinion Letters and to refrain from issuing the 1972 Opinion Letters in the form they actually took" (¶ 30). Specifications of the fraud which would have been discovered are contained in paragraph 29 of the complaint.

H. The Impact of the Misfeasance and Nonfeasance of Touche Ross

The direct and proximate results of Touche Ross' misfeasance and nonfeasance are enumerated in nine specifications set forth in paragraph 31 of the complaint. These specifications include Touche Ross' facilitation of Weis' subsequent falsification of financial information during fiscal year 1973; the deception of SIPC, the Exchange, the SEC, and customers and other creditors of Weis into believing "that as of May 26, 1972 Weis was in sound financial condition and in compliance with applicable financial responsibility rules"; the prevention of the possibility of timely remedial action to avert a liquidation under SIPA; Weis' resulting inability "to comply with the minimum financial responsibility rules"; and the eventual, un-

avoidable liquidation of Weis under SIPA which "caused and continues to cause substantial injury to Weis and SIPC as well as Weis' customers, creditors, lenders, and shareholders".

I. SIPC's Eight Claims against Touche Ross

As earlier noted, SIPC has pleaded four claims in its own right (Claims I, III, V & VII), and four as subrogee of the customers of Weis whose claims were satisfied through the depletion of the SIPC fund (Claims II, IV, VI & VIII). Except for the fact that the subrogation claims call into play a different class to whom Touche Ross owed its duty, they involve substantially the same gravamen as do SIPC's direct claims, two of which (Claims I and III) plead rights of action arising under the 1934 Act, and two of which (Claims V and VII) plead Touche Ross' common law liability.

1. *SIPC's Direct Claims*

Claim I— After realleging the Common Allegations (¶ 50), as do each of the subsequent claims, this claim alleges that Touche Ross' audit failed to comply with applicable standards under the 1934 Act in that its opinion letters, the financial statements and the Answers to Exchange Questionnaires "were false, inaccurate and incomplete" (¶ 51). As a result of Touche Ross' breach of duty to SIPC, the liquidation of Weis under SIPA became necessary and SIPC was damaged by at least fourteen million dollars (¶¶ 52-53). The damages alleged in each subsequent claim are the same.

Claim III—This claim alleges that "Touche Ross had knowledge of or, but for its errors and omissions, should have had knowledge of" the fraud perpetrated by Weis' officers, in violation of the 1934 Act and the rules thereunder (¶ 60); that Touche Ross breached its duty of disclosure to SIPC (¶ 61); and that, by reason of its acts

and omissions, aided and abetted the fraud perpetrated by Weis' officers in violation of the 1934 Act (¶ 63).

Claim V—This claim alleges "the negligence and malpractice of Touche Ross" in violation of its duty to SIPC (¶ 72).

Claim VII—This claim alleges that Touche Ross' audit was conducted "in so reckless and grossly negligent a manner that Touche Ross knew or should have known" that its opinion letters, the Answers to Exchange Questionnaire and the financial statements were "false, inaccurate and incomplete", and that Touche Ross breached the duty it owed SIPC (¶ 80).

2. *SIPC's Subrogation Claims*

As earlier noted, SIPC's subrogation claims carry forward the gravamen of its direct claims. Thus, Claim II is predicated on Touche Ross' breach of its duties under Section 17 to Weis' customers (¶¶ 55, 57); Claim IV asserts that Touche Ross aided and abetted the Weis Five's violation of the duties owed under Section 17 to Weis' customers (¶¶ 65, 66, 68); Claim VI states Touche Ross' negligence and malpractice in violation of its duties to Weis' customers (¶¶ 74, 76); and Claim VIII alleges Touche Ross' recklessness and gross negligence in violation of its duties to Weis' customers. With respect to each of these claims, SIPC asserts that it is subrogated to those claims which such customers of Weis who have been paid out of the SIPC fund could have asserted against Touche Ross (¶¶ 57, 68, 76, 84).

Summary of Argument

Section 27 of the 1934 Act gives the district courts "exclusive jurisdiction of violations of this title or the rules and regulations thereunder and of all suits in equity

and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder". The basic questions on this appeal are whether Section 17 of the 1934 Act imposes a duty upon accountants to prepare accurate and reliable reports, and whether their failure to do so subjects them to liability to those who (like SIPC) must rely on them to carry out their statutory functions and to those who (like Weis' customers) must rely on them in deciding to entrust their cash or securities to a broker-dealer. We believe Touche Ross has the duty and SIPC has the right to enforce violations of that duty both in its own right and as the subrogee of Weis' customers.

SIPC contends that the District Court erred in summarily concluding that Section 17 was merely "designed to supply administrative guidance in the bookkeeping area" (A 400a) because, in so doing, the Court failed to realize, and denied SIPC the opportunity to establish through discovery or at trial, the *facts* concerning the creation of SIPC and its functions, the objectives sought by Congress and the regulatory authorities in requiring Section 17 financial reports to be filed, the obligations assumed by Touche Ross in preparing and certifying such reports, the reliance by SIPC, the SEC, the Exchange and Weis' customers on such reports, and the interrelationship between SIPC, the SEC and the Exchange in effectuating their respective roles in the scheme devised for the protection of the customers of broker-dealers.

Accordingly, SIPC shall demonstrate, under Point I *infra,* the integral part Section 17 plays in the statutory and regulatory scheme created for the benefit of both the SIPC fund and Weis' customers. The gist of SIPC's argument under Point I is that, since the Section 17 reports are the only means by which SIPC—which has no authority to examine its members—may detect that a broker-dealer has failed or is in danger of failing to meet its obligations to its customers, so long as the Section 17 reports prepared and certified by Touche Ross were false

and misleading, SIPC and Weis' customers were deceived into assuming or believing that Weis was not in or approaching financial difficulty, and, therefore, SIPC was prevented from avoiding or minimizing the losses which Weis' customers—and ultimately SIPC itself—suffered. The District Court simply belittled the fact that the Section 17 reports are at the core of the early-warning system established by the 1934 Act—and enhanced by SIPA—to enable the SEC, the Exchange and SIPC to take immediate and appropriate action for the protection of the customers of broker-dealers.

Moreover, as shall be demonstrated under Point II *infra*, the District Court's holding that a right of action may not be implied under Section 17 was based on a series of erroneous premises. Thus, in linking Section 17 to Section 18 of the 1934 Act, the Court ignored the fact that the Act was intended to have a two-fold purpose—to protect purchasers and sellers of securities (a purpose clearly effectuated by Section 18) *and* to protect customers of broker-dealers (a purpose obviously addressed by Section 17). In the context of this case, Section 18 is simply not relevant to the consideration of Section 17, and, indeed, the reading of a purchaser-seller requirement into the latter Section denies to a broker-dealer's customers the protection intended by Congress.

Similarly, by suggesting that the absence of an express provision for a right of action under Section 17 should be construed to prohibit the implication of such a right, the Court overlooked the fact that the courts, as best illustrated by *J. I. Case* v. *Borak*, 377 U.S. 426 (1964), have traditionally recognized implied remedies as a method for enforcing the 1934 Act. Likewise, the Court erred in finding that the Section 17 reports involved in this case were not intended for the benefit of either SIPC or Weis' customers and were independently verified by the SEC, because both SIPC and Weis' customers were direct beneficiaries of the duties imposed upon Touche Ross by Sec-

tion 17, and neither the SEC nor the Exchange independently verified—indeed, they were not expected to verify—the false and misleading reports certified by Touche Ross. Finally, by stating that criminal prosecutions and SEC injunctive actions can adequately substitute for private actions under Section 17, the Court was simply not realistic: criminal prosecution has not proven to be an effective deterrent and would hardly restore fourteen million dollars to the SIPC fund; and, as the Weis debacle itself highlights, injunctive relief is a remedy which comes too late and offers too little.

POINT I

The District Court improperly ignored the fact that the Section 17 reports certified by Touche Ross are the cornerstone for the legislative and regulatory scheme devised to protect the SIPC fund and Weis' customers.

Whether a right of action under Section 17 may be implied in favor of SIPC depends, of course, on the Congressional intent in enacting that Section and SIPA and on the manner by which SIPC supplements the scheme set up by that Section and the rules thereunder. Similarly, whether a right of action may be implied in favor of Weis' customers (SIPC's subrogors) depends on Congressional intent and on the extent to which accurate Section 17 reports are vital to the efficacy of the system designed for the customers' protection. Accordingly, the following exposition will demonstrate that which the District Court ignored and denied SIPC the opportunity to prove: both SIPC and Weis' customers necessarily relied on the accuracy of the Section 17 reports prepared and certified by Touche Ross, and, indeed, their reliance was mandated by the statutory and regulatory scheme intended for their protection.

A. The Purposes of SIPA

SIPA is an integral part of the scheme for customer protection instituted by the federal securities laws in general and by the net capital rule (to be discussed *infra*) in particular. Indeed, Section 78bbb of SIPA states that ". . . the provisions of [the 1934 Act] apply as if this Act constituted an amendment to, and was included as a section of, such Act."

The background and purposes of SIPA were succinctly stated in *SIPC* v. *Barbour,* 421 U.S. 412, 415 (1975):

> "Following a period of great expansion in the 1960s, the securities industry experienced a business contraction that led to the failure or instability of a significant number of brokerage firms. Customers of failed firms found their cash and securities on deposit either dissipated or tied up in lengthy bankruptcy proceedings. In addition to its disastrous effects on customer assets and investor confidence, this situation also threatened a 'domino effect' involving otherwise solvent brokers that had substantial open transactions with firms that failed. *Congress enacted the SIPA to arrest this process, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers.*" (citations omitted, emphasis added)

The last stated purpose, that of up-grading broker-dealer responsibility, was aimed at eliminating ". . . to the maximum extent possible, the risks which lead to customer loss." H.R. Rep. No. 91-1631, 91st Cong. 2d Sess. 28 (1970).

SIPA accomplished its purposes essentially by two methods. First, SIPA enhanced the SEC's power to establish financial responsibility rules for brokers and dealers and to impose on the self-regulatory organizations requirements for the financial examination of their mem-

bers. Thus, Section 78ggg(d) of SIPA amended Section 15c(3) of the 1934 Act so as to broaden the SEC's powers with regard to financial responsibility rules and so as to require that such rules provide for the maintenance of reserves with respect to customers' deposits or credit balances. Similarly, Section 78iii of SIPA gave the SEC plenary authority over the self-regulatory organizations ". . . with respect to the frequency and scope of inspections and examinations relating to the financial condition of members of such self-regulatory organizations and the selection and qualification of examiners. . . ."* In addition, SIPC is directed by Section 78iii(e) of SIPA to work with the self-regulatory organizations toward the standardization of their examining procedures and the development of procedures for the early detection of the financial difficulty of SIPC members. This first method by which SIPA's purposes are accomplished was undermined by Touche Ross because its preparation and certification of Weis' inaccurate and misleading Section 17 reports deceived the SEC, the Exchange and SIPC into assuming that Weis was in compliance with the financial responsibility rules to which it was subject pursuant to the 1934 Act as enhanced by SIPA.

The second method by which SIPA accomplished its purposes was the creation of SIPC which was empowered, *inter alia*: to commence proceedings for the liquidation of its members whose financial condition posed the threat of loss to their customers; and to satisfy, within certain limits, the claims of those customers against the SIPC member's estate. Thus, SIPC was created as a fail-safe device to avoid or minimize the losses which the cus-

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* See also, Section 78kkk(h) of SIPA which directed the SEC to report to Congress concerning unsafe and unsound broker-dealer practices and to make recommendations for their elimination. This resulted in the *Report and Recommendations of the Securities and Exchange Commission, Study of Unsafe and Unsound Practices*, H.R. Doc. No. 92-231, 92nd Cong. 1st Sess. 2426 (1971) (hereinafter referred to as "*The Study*").

tomers of broker-dealers may suffer as a result of the latter's financial difficulty. That fail-safe device was triggered upon the belated discovery of Weis' true financial condition. Consequently, SIPC made over fourteen million dollars available to the Trustee for the satisfaction of certain customer and creditor claims. SIPC now seeks to recover those fourteen million dollars from Touche Ross, but for whose misfeasance and nonfeasance in certifying the Section 17 reports the depletion of the SIPC fund would not have occurred.

It must further be noted that, as the Supreme Court has recognized, the SEC's role is "one of 'plenary authority' to supervise SIPC". *SIPC* v. *Barbour, supra* at 417.* Indeed, in light of the intimate nexus between SIPC and the SEC, it can hardly be said that SIPC is seeking to enforce a "private" right of action under Section 17.

B. The Significance of Section 17 and the Rules and Forms Thereunder

The legislative concern with investor protection which underlies SIPA also underlies Section 17 of the 1934 Act. Indeed, the concept of investor protection was the major underlying legislative concern of both the Securities Act of 1933 and the 1934 Act. See, *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, *rehearing denied*, 423 U.S. 884 (1975); *Zeller* v. *Bogue Electric Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973). The 1934 Act itself has a two-fold purpose—to protect the purchasers or sellers of securities (e.g. Sections 10b, 13a and 18) and to protect the customers of broker-dealers (e.g. Sections 15c and, of course, 17a).

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* The extent of the SEC's control over SIPC is clearly reflected in SIPA: see, *e.g.*, §§78ccc(e), 78ddd(g) and (h); 78ggg(b) and (c).

As effective in 1972, Section 17a provided that a broker-dealer such as Weis shall ". . . *make such reports,* as the [SEC] by its rules and regulations may prescribe as *necessary or appropriate in the public's interest or for the protection of investors*" (emphasis added).* Pursuant to this provision, the SEC adopted Rule 17a-5 which required brokers and dealers to submit reports of their financial condition at least annually on a Form X-17A-5 to the SEC and to the self-regulatory organizations of which they were members.** Prior to the adoption of the Rule, in rejecting report forms proposed by the National Association of Security Dealers, the *SEC noted that customer protection against the risk involved in leaving securities with broker-dealers would be increased by Rule 17a-5. National Association of Securities Dealers,* 12 SEC 322, 339, n.9 (October 28, 1942).

In order to effectuate that purpose of customer protection, Section 17 and the rules and forms thereunder call for the gathering, analysis and disclosure of a broad range of information. *This information is intended to provide a detailed and complete picture of the financial condition of the broker-dealer, and of the procedures and controls employed by the broker-dealer for safeguarding the property of its customers.* Thus, for example, the report filed by a broker-dealer must include a financial statement and supporting schedules (Rule 17a-5(b)(2); it must be followed within 30 days by a certified balance sheet based on the report of financial condition, a statement of income, a statement of source and application of funds, and a statement of changes in subordinated accounts (Rule 17a-5(k)(1) and (3)); it must state any matters as to which the accountant takes exception (Rule

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* The full text of Section 17 as in effect in 1972 appears in the Joint Appendix at 284a.

** The full text of Rule 17a-5 as in effect in 1972 appears in the Joint Appendix at 285a.

17a-5(i)); and, if the accountant comments on any "material inadequacies found to exist in the accounting system, the internal accounting control procedures or the procedures followed in complying with Rule 17a-13, there must be a statement" by the broker-dealer, making such comments available for customer inspection (Rule 17a-5 (n)(3)).

With respect to the last requirement, known as the "material inadequacy letter", the SEC has stated:

> "A material inadequacy . . . which is expected to be reported includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (a) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other broker-dealers or creditors; (b) result in material financial loss; (c) result in material misstatements of the brokers or dealers financial statements; or (d) result in violations of the Commission's record-keeping or financial responsibility rules or rules *which the accountant is specifically required to review pursuant to Rule 17a-5 and Form X-17A-5 thereunder.*
>
> "In this regard, it is the [SEC'S] view that both the public interest and the broker-dealer community are not properly served if weaknesses are considered material only after such inadequacies have resulted in substantial financial loss. *Accordingly, it is incumbent upon the independent public accountant to report those inadequacies which in the exercise of his professional judgment could reasonably be expected to result in a substantial adverse impact if appropriate corrective action is not promptly taken,* irrespective of the financial condition of the broker or dealer" (emphasis added) 1934 Act Release No. 10398, September 20, 1973 [1973 Transfer Binder], Fed. Sec. L. Rep. (CCH), ¶79,516.

The single most egregious "inadequacy" which could befall a broker-dealer is to fail to comply with the net capital rule, which requires a broker-dealer to maintain a certain ratio of liquid assets to aggregate indebtedness. *"The principal purpose of the [net capital] rule is to require that the capital position of a broker or dealer will always be sufficiently liquid to cover his current indebtedness, in order to be able at all times to promptly meet the demands of customers."* (emphasis added) 1934 Act Release No. 8024, Jan. 18, 1967, 6 Fed. Sec. L. Rep. (CCH), ¶ 72,129.

The significance of the net capital rule for the protection of customers of broker-dealers cannot be over-emphasized and will be explained in some detail below. Suffice it to say at this point that *Section 17 provides the mechanism for the detection and reporting of non-compliance with the net capital rule.* Thus, Rule 17a-11 requires, *inter alia*: first, that when the net capital of a broker-dealer is less than required by the applicable net capital rule, it give immediate telegraphic notice to the SEC and the self-regulatory bodies of which it is a member; second, that it give immediate telegraphic notice of its failure to keep current books and records, including a report within 48 hours stating steps taken to correct the deficiency; and third, that it file a detailed report (Form X-17A-11) furnishing data as to its financial and operational conditions.*

It is manifest that taken together the rules under Section 17 provide an impressive arsenal for the protection of those who deposit cash or securities with broker-dealers. *The Section 17 reports form the nucleus of an early warning system which is indispensable to the SEC and self-regulatory organizations, such as the Exchange, in*

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* The Form "requests specific data which has proven to be of significance in the past with regard to brokerage failures". 1934 Act Release No. 9268, July 30, 1971, [1970-71 Transfer Binder], Fed. Sec. L. Rep. (CCH), ¶78,169 at 80532-33.

carrying out their regulatory and oversight responsibilities (*The Study*, at 31).*

Of course, if—as in the case of Touche Ross' 1972 audit of Weis—the Section 17 reports are inaccurate and misleading, the regulatory and oversight function is thwarted and the protection which would otherwise be afforded to the broker-dealer's customers is denied.

C. The Relationship of Section 17 to the Net Capital Rule

The "net capital" of a broker-dealer is essentially its adjusted "net worth", as defined in SEC Rule 15c(3)-(1). As previously noted, the net capital rule requires a broker-dealer to maintain a certain ratio of liquid assets to aggregate indebtedness in order to be able to promptly meet the demands of customers at all times.

The net capital rule was obviously intended to lessen the risks involved when a customer deposits cash or securities with a broker-dealer. See, S. Rep. No. 1455, 73rd Cong. 2d Sess. 12-15 (1934); I. L. Loss, *Securities Regulation* 130, 131 (2d ed. 1961). The legislative history underlying the financial responsibility rules promulgated by the SEC makes clear that "Congress did not intend to permit a broker/dealer to continue operation unless he had on hand cash or liquid assets in the required ratio to aggregate indebtedness." See, *Report of the Committee on Interstate And Foreign Commerce*, H.R. Rep. No. 1613, 91st Cong. 2d Sess. 12 (1970); *SEC* v. *General Securities Co.*, 216 F. Supp. 350 (S.D.N.Y. 1963). Thus, *the net capital rule is the "principal regulatory tool" used by the SEC to monitor the financial soundness of brokers and dealers.* Press Release, January 10, 1973 [1972-73 Transfer Binder], Fed. Sec. L. Rep. (CCH), ¶78,174 at 82,578 (remarks to Senator Harrison A. Williams, Chair-

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* See also, 1934 Act Release No. 9404, Dec. 3, 1971 [1971-72 Transfer Binder], Fed. Sec. L. Rep. (CCH), ¶78,447 at 80976-81.

man of the Senate Securities Subcommittee). The courts have described the rule as "the most important weapon in the [SEC's] arsenal to protect investors" (*Blaise D'Antoni & Associates, Inc.* v. *SEC*, 289 F.2d 276, 277 (5th Cir. 1961), *cert. denied*, 368 U.S. 899 (1961)) and as "one of the most important provisions designed to protect the investing public . . ." (*Hughes* v. *Dempsey-Tegler & Co., Inc.*, 534 F.2d 156, 173 (9th Cir. 1976). See also, *SEC* v. *General Securities Co.*, 216 F. Supp. 350, 351 (S.D.N.Y. 1963).

In fact, as early as 1942, the SEC stated that "customers do not open accounts with a broker relying on suit, judgment and execution to collect their claim—they are opened in the belief that a customer can, on reasonable demand, liquidate his cash or securities position". *Guy D. Marianette*, 11 SEC 967, 971. More recently, the SEC announced certain amendments to the net capital rule and reiterated its policies:

> ". . . *the amount of the firm's liquid assets in excess of the broker's or dealer's minimum requirement necessary to protect customers gives the* [*SEC*], *self-regulators and SIPC sufficient early warning to take appropriate action to protect customers prior to the time when the broker's or dealer's assets would be sufficient to satisfy customers claims in the event of liquidation.*" (emphasis added) 1934 Act Release No. 11497, June 26, 1975 [1975-76 Transfer Binder], Fed. Sec. L. Rep. (CCH), ¶80,212.

Weis, as a member of the Exchange, was exempt from the SEC's net capital requirements and was subject to the more stringent net capital requirements of Exchange Rule 325, promulgated by the Exchange pursuant to Section 6(d) of the 1934 Act.* Accordingly, Weis was not per-

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*SEC Rule 15c(3)(1)(b)(2) exempts members in good standing of certain national exchanges. The exemption is granted by the SEC following its review of the Exchange rule and its determination that the Exchange rule is more comprehensive. See, 1934 Act Release No. 3617, Nov. 8, 1944.

mitted to allow its "aggregate indebtedness" to exceed 1500% of its "net capital" as those terms are defined in Exchange Rule 325. (The SEC's Rule required a less stringent 20 to 1 ratio.) However, the basic purpose—to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers—is fulfilled whether the broker-dealer is subject to the Exchange's net capital rule or to the SEC's less stringent rule.

Through the requirements of Section 17 and the rules and forms thereunder, the SEC and the Exchange obtain the information necessary to enforce the net capital rule. For example, Form X-17A-5 "is designed to reflect the financial condition of the reporting broker and dealer; and, accordingly, it contains details calculated to reveal whether or not the broker-dealer is in compliance with, among other things, applicable net capital requirements" (*The Study*, at 24). Likewise, net capital computations are required by Rule 17a-5(j) and (m), and immediate telegraphic notice of non-compliance with the net capital rule is required by Rule 17a-11. In addition, Note (B) and Requirement (8) of the "Regulations Prescribed for Audit under Authority of Exchange Rule 417" (*NYSE Guide* (CCH), ¶ 2417.10) require the auditor to verify the computation of the ratio of "aggregate indebtedness" to "net capital" in accordance with Exchange Rule 325 and to review the procedures followed by the broker-dealer in making his monthly net capital computation pursuant to Rule 17a-3(a)(11).

Simply put, Section 17 provides the means for determining net capital compliance. Again, if the Section 17 reports prepared and certified by the auditor are inaccurate and misleading, the Exchange—and thus SIPC—will assume that the broker-dealer is operating within the confines of the net capital rule. As a result, customer protection will be avoided until—as in the case of Weis—a forced liquidation and the consequent depletion of the SIPC fund become inevitable.

D. The Accountant's Responsibility under Section 17

Rule 17a-5 provided that the information required by Form X-17A-5 ". . . be certified by a certified public accountant or a public accountant who shall in fact be independent . . ." (Rule 17a-5(a) and (b)(1)). It is noteworthy that certification was not required if the broker-dealer's business was such as not to endanger customer cash or securities (Rule 17a-5(b)(1)).

Form X-17A-5 sets forth the "Audit Requirements" to be followed by the accountant:

> "The audit shall be in accordance with generally accepted accounting standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities, including appropriate tests thereof, for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent [broker-dealer firm] at that date."

Augmenting this were Subsections (g), (h) and (i) of Rule 17a-5 which provided the standards for the requirements, representations and opinions of the accountant's certificate.

Congress considered, but ultimately rejected, requiring the government itself to audit filings with the SEC. Instead, however, Congress decided that such filings be audited by independent public accountants:

> "The Committee also considered the advisability and feasibility of requiring that the audit be made by accountants on the staff of the agency administering the Act. In the report on the bill, the Senate

> Committee stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary in carrying out the provisions of the bill, but it was determined essentially to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security. *The proposal to require certification of independent public accountants was incorporated in the bill as passed.*" SEC Accounting Series Release No. 81 (1958), 5 Fed. Sec. L. Rep. (CCH), ¶72,103 (1964).

See also, Sonde, "The Responsibility of Professiorals under the Federal Securities Laws—Some Observations", 68 N.W.U.L. Rev. 1, 2 (1973):

> "Although it was initially proposed that the Government hire a corps of auditors to perform the audit responsibility for financial statements filed with the [SEC], it was decided that such statements be audited by independent public accountants. *This decision was based upon the accounting profession's representation that it was willing and able to assume this responsibility.*" (footnotes omitted).

Moreover, among the early amendments to Rule 17a-5 was a broadening of the certification requirements, which prompted the following statement in the SEC News Digest for August 8, 1957 (at 3):*

> "[The amendment] . . . adds another important protective feature to the [SEC's] continuing program for improving the safeguards afforded to customers of broker-dealer firms. . . . *The [SEC] believes that it is essential, for the protection of*

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* Adoption of the amendment to Rule 17a-5(b)(1) was announced by 1934 Act Release No. 5560, August 8, 1957.

> *public investors, that the accounts of these broker-dealers who do business with the investing public and handle customer funds and securities be subject to an annual audit by an independent accountant.*" (emphasis added)

Thus, the accurate disclosure of financial information about the operations of broker-dealers has been so vital a safeguard for customers of those broker-dealers that it was deemed essential to have independent—and, most often, certified—audits.

The accounting profession itself recognizes, of course, that accountants who prepare the reports of broker-dealers bear a heavy responsibility to the broker-dealers' customers and to the regulatory authorities. Thus, the preface to *Audits of Brokers and Dealers in Securities,* a book published by the Committee on Stockbrokerage Auditing of the American Institute of Certified Public Accountants, notes:

> ". . . *The forms of financial reporting of broker-dealers, in accordance with requirements established by the regulatory or self-regulatory bodies, are intended to meet the needs of customers who do business with these securities concerns, the regulatory bodies* and, in the case of firms with public ownership, the needs of stockholders." (emphasis added) *Id.* at ix.

In fact, a Touche Ross partner who worked on the 1972 Weis audit has written:

> ". . . *it is our responsibility to determine when financial statements do not present fairly the financial position of a company. Therefore, if a fraud is so pervasive as to destroy the very fabric of the financial statements we audit, we must strive to detect this condition.* We may not always be successful, but we cannot afford to fall back on the thinking that collusive actions always defeat in-

> ternal controls and circumvent audit techniques. This negativism would stultify all efforts to discover such problems and thus be abandonment of duty. *Therefore, I believe that the performance gap between public (here, the SEC) expectations and reality can be narrowed.*" (emphasis added) Weinstein, "A Time of Travail and Challenge", 44 CPA J. 29 (Dec. 1974).*

Naturally, the SEC agrees:

> "*The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies.*
>
> * * *
>
> *The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client.*" (emphasis added) *In the Matter of Touche, Niven, Bailey & Smart,* Accounting Series Release No. 78 (1957), 5 Fed. Sec. L. Rep. (CCH), ¶72.100 at 62,212.

And the recognition of the accountant's grave responsibility has not escaped the courts. Thus, in *Gold* v. *DCL, Inc.,* 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973), the court stated:

> "*Where it gives an opinion or certified statement, an auditing firm publicly assumes a role that carries a special relationship of trust vis-a-vis the public.* The auditor in such a case holds itself out as an independent professional source of assurance that the audited company's financial presentation is accurate and reliable."**

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* In its answers to plaintiffs' preliminary interrogatories, Touche Ross listed Mr. Weinstein as one of its partners who had worked on the 1972 Weis audit (A 94a).

** See also *e.g., Heit* v. *Weitzen,* 402 F.2d 909, 913 (2nd Cir. 1968) *cert. denied,* 395 U.S. 903 (1969); *United States* v. *Natelli,* 527 F.2d 311, 319 (2nd Cir. 1975), *cert. denied,* 425 U.S. 934 (1976).

As Judge Friendly has so aptly stated:

> "*In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.*" *United States* v. *Benjamin*, 328 F.2d 854, 863 (2nd Cir. 1964), *cert. denied, sub. nom. Howard* v. *United States*, 377 U.S. 953 (1964).

Judge Friendly's observation emphasizes the heavy responsibility borne by Touche Ross in preparing and certifying the Section 17 reports and the injurious impact which Touche Ross' certification had on those who—like SIPC and Weis' customers—relied on the accuracy of those reports.

E. SIPC's Reliance on the Accountant

As previously noted, SIPC has no authority to examine its members. Rather, under Section 6 of the 1934 Act, it is the Exchange's responsibility to regulate and monitor its members, especially in the area of financial responsibility. See, Sections 6a through 6d of the 1934 Act and Sections 78eee(a)(1), 78hhh, 78iii and 78*lll* of SIPA; see also, *SIPC* v. *Barbour, supra* at 416.

Under Section 78eee(a)(1) of SIPA, the Exchange had a duty to keep SIPC informed of the financial difficulties of Weis as they intensified and were discovered. Therefore, SIPC necessarily relied on the Exchange in order to make its statutorily mandated determination that Weis "has failed or is in danger of failing to meet its obligations to customers and there exists one or more of the conditions specified [in SIPA as evidence of such failure to meet obligations]" (Section 78eee(a)(2) of SIPA).

The essential financial information concerning Weis obtained by the Exchange, and hence SIPC, was contained in the Section 17 reports prepared and certified by Touche Ross. Indeed, at least three of the five conditions specified

in SIPA as indicia of a broker-dealer's actual or potential failure to meet its obligations can only be—and should be—reflected in the audited reports filed pursuant to Section 17 and the rules and regulations promulgated thereunder.* Thus, *it is only by receiving accurate information in the Section 17 reports that the Exchange—and, of course, SIPC—could immediately protect Weis' customers and thereby effectuate the purposes of the net capital rule, the 1934 Act and SIPA.*

Specifically, a broker-dealer's failure to comply with the requirements of the net capital rule is one of the conditions specified in SIPA which may precipitate the liquidation of the broker-dealer. Sections 78eee(b)(1)(A)(iv) and (v) and 78*lll*(2) of SIPA. In 1972, Weis was in fact in violation of the Exchange's net capital rule to which it was subject.**

Had Touche Ross prepared and certified accurate Section 17 reports, the Exchange—and through it, SIPC—would have been alerted to the fact that Weis was in net capital violation, and the forced liquidation of Weis could have been avoided by timely remedial action which would have prevented, or at least minimized, the damages suffered by Weis' customers and by SIPC.

In sum, the deception caused by Touche Ross through the Section 17 reports deprived Weis' customers of the protection Congress intended them to have and resulted in the concomitant depletion of the SIPC fund by fourteen million dollars. By reason of Touche Ross' breach of the

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* Those three conditions are: (i) insolvency; (iv) failure to comply with financial responsibility rules; and (v) inability to establish compliance with financial responsibility rules (Section 78eee(b)(1)(A) of SIPA).

** Weis' violation of the Exchange's net capital rule was a condition alleged by SIPC in its application initiating the Weis liquidation proceeding in the United States District Court for the Southern District of New York.

duties it owed to SIPC under Section 17, SIPC is entitled to recover, *in its own right,* the funds it provided to the Trustee for the payment of the claims submitted by customers and certain other creditors of Weis and for some administrative expenses of the Weis liquidation.

F. The Customers' Reliance on the Accountant

Based on the foregoing, there simply can be no doubt that SIPA, Section 17 and the rules and regulations thereunder, the net capital rule, and the related functions performed by the SEC, the Exchange and SIPC, were all designed for the protection of a broker-dealer's customers, such as SIPC's subrogors in this case. It is equally manifest that the accountant who prepares and certifies the Section 17 reports bears a grave responsibility indeed, by reason of the fact that the SEC, the Exchange and SIPC rely on those reports in carrying out their respective roles in the system devised for the protection of a broker-dealer's customers. Of course, the customers themselves rely on the efficacy of that system. And, so long as an accountant prepares and certifies false and misleading Section 17 reports, as did Touche Ross, the system is defeated and its purpose is frustrated.

Had SIPA not been enacted and the SIPC fund not been created, Weis' customers would clearly have a cause of action under Section 17 against Touche Ross for the latter's breach of the duties it owed to them under that Section. Certainly, the SIPC fund was not intended to be a windfall benefiting wrongdoers such as Touche Ross. If Touche Ross would have been liable for its wrongdoing prior to the enactment of SIPA, it may not be allowed to take advantage of that Act to escape liability. Accordingly, SIPC is entitled to step into the shoes of Weis' customers and, *as subrogee,* to recover from Touche Ross the payments made to those customers out of the SIPC fund.

POINT II

The District Court improperly dismissed SIPC's claims under Section 17 of the 1934 Act.

The District Court's dismissal of SIPC's four claims (two in its own right and two as the subrogee of Weis' customers) under Section 17 of the 1934 Act was based on the following series of erroneous premises:

> —that the purchaser-seller requirement of Section 18 should be read into Section 17;
>
> —that the absence of an express provision for a right of action under Section 17 should be construed to prohibit the implication of a right of action thereunder;
>
> —that the Section 17 reports were not intended for the benefit of either Weis' customers or SIPC, and were independently verified by the SEC; and
>
> —that criminal prosecutions and SEC injunctive actions are adequate substitutes for the right of action under Section 17 asserted by SIPC.

Based upon the allegations of the complaint and the discussion contained herein under Point I, SIPC contends:

> —that Section 18, which is concerned with the rights of purchasers and sellers of securities as against an issuer, is irrelevant in the context of this case to Section 17, which protects customers from the broker-dealers with whom they do business;
>
> —that the recognition of an implied right of action within the narrow confines of this case would be entirely consistent with the historical enforcement of the 1934 Act through judicial recognition of implied remedies thereunder;

—that both Weis' customers and SIPC were direct beneficiaries of the duties imposed upon accountants by Section 17, and neither the SEC nor the Exchange independently verified—indeed, they were not expected to verify—the false and misleading Section 17 reports prepared and certified by Touche Ross; and

—that the recognition of the right of action under Section 17 sought by SIPC is necessary for the effective enforcement of that Section, for the actual deterrence of wrongdoers such as Touche Ross, and for the restoration to SIPC of the funds of which it is deprived by the misfeasance and nonfeasance of those who, like Touche Ross, violate the duties owed under Section 17 to SIPC and the customers of broker-dealers.

A. In the context of this case, Section 18 of the 1934 Act has no relevance to Section 17.

The District Court inferred that Congress intended to make Section 18 of the 1934 Act the exclusive remedy for a violation of Section 17. Section 18 provides, in pertinent part:

> "(a) Any person who shall make or cause to be made any statement in any application, report or document filed pursuant to this title or any rule or regulation thereunder . . ., which statement was at the time and in the light of the circumstances under which it was made false and misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) *who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement,* for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. . . ." (emphasis added)

By suggesting that the purchaser-seller requirement of Section 18 must be satisfied by persons suing under Section 17, the District Court took a one-sided view of a two-sided statute. Weis was not an issuer of securities within the contemplation of Section 18, and obviously neither SIPC nor Weis' customers (SIPC's subrogors) purchased or sold any Weis stock. Weis was, on the other hand, a brokerage firm and, as such it was subject to the reporting requirements of Section 17, which were conceived by Congress as a means of protecting Weis' customers and relied upon by SIPC in assuming that Weis was not in financial difficulty when in fact it was. Thus, SIPC and Weis' customers can not—nor should they be required to —meet the purchaser-seller requirement of Section 18.

To limit the protection afforded by the 1934 Act to purchasers and sellers of securities is to overlook the other, equally fundamental purpose of that Act—the protection of the customers of broker-dealers. As shown above, the legislative history of the 1934 Act in general and of Section 17 in particular, the rules and regulations promulgated under that Section, the relationship of reports filed under that Section to the all-important net capital rule, and the very enactment of SIPA, all demonstrate that the protection of a broker-dealer's customers, *irrespective of any purchaser-seller requirement,* has been a central concern of Congress, the SEC and the self-regulatory organizations. SIPC is simply asking that this Court, unlike the District Court, share in that concern.

First of all, "Section 18(a) is to be construed according to its terms and its 'coverage . . . is no broader than that indicated by the plain meaning of its language' ". (citation omitted) *Rich* v. *Touche Ross,* Fed, Sec. L. Rep. (CCH), ¶95,514 at 99,633 (S.D.N.Y. 1976). The language used in Section 18(a) provides a remedy only for a person who has purchased or sold a particular security at a price affected by a misrepresentation upon which he has relied. Manifestly, Congress did not enact Section 17 with the intent that Section 18 would be the sole remedy for its violation since "[t]he misstatements in the Form X-17A-5

. . . plainly could not influence the market prices of the shares of the various issuers which plaintiffs held." *Id.* at 99,634.

Secondly, not a single one of the cases cited by the District Court (A 402a) held that Section 18 provides the exclusive remedy for violations of Section 17. In fact, in each one of the cases cited, the purchaser-seller requirement of Section 18 was merely held applicable to Section 13 of the 1934 Act. *Meer* v. *United Brands Co.*, Fed. Sec. L. Rep. (CCH), ¶95,648 at 90,213-24 (S.D.N.Y. 1976); *Myers* v. *American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213, 214-215 (S.D.N.Y. 1975); *In Re Penn Central Securities Litigation*, 347 F. Supp. 1327, 1340 (E.D. Pa. 1972), *reargued* 357 F. Supp. 879 (E.D. Pa. 1973), *aff'd* 494 F.2d 528 (3rd Cir. 1974).* Moreover, it should be noted that Section 13 is concerned only with the reports which *issuers and certain purchasers of securities* are required to file. It has nothing whatsoever to do with the protection Congress intended to afford to the *customers of broker-dealers* through Section 17. Unlike both Sections 13 and 18, Section 17 is simply not addressed to the protection of purchasers and sellers of the securities of listed corporations.

Moreover, the legislative history of Section 18 is barren of any reference to liability for the false and misleading reports of broker-dealers filed pursuant to Section 17.** Rather, at the Senate hearings on Section 18, Mr. Altschul, Chairman of the Exchange's Committee on Stock List, found it ". . . impossible for *corporations* to comply with

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* The Pennsylvania District Court's reference to Section 17 in the *Penn Central* case was purely *dictum*. No mention of Section 17 was made either by that Court in its second decision or by the Third Circuit.

** See generally, *Stock Exchange Practices*, Hearings before the Committee on Banking and Currency on S. Res. 84, 56 and 97, 73rd Cong. 1st Sess., Part 15 (1934) (hereinafter referred to as "*Stock Exchange Practices*").

[the] terms" of Section 18 (*Stock Exchange Practices,* at 6697). Because only *individuals*—not corporation—could be members of the Exchange,* Mr. Altschul obviously did not view Section 18 as having any impact on broker-dealers. Further statements concerning the impact of Section 18 on "corporation", "listed corporation" and "listed companies" also appear—all without any reference to broker-dealers. See, *e.g., Stock Exchange Practices,* at 6673, 7186, 7281 and 7282.

The foregoing conclusively demonstrates that the District Court's joinder of Sections 17 and 18 is not supported by the language and legislative history of the latter Section or by relevant precedent. Far from addressing itself to the protection of the customers of broker-dealers, Section 18 is concerned with the reports to be filed for the protection of purchasers and sellers of securities—such as the reports required of issuers and certain purchasers of securities by Section 13. It is respectfully submitted that the District Court erred in deeming Section 18 relevant to Section 17.

B. The recognition of an implied right of action under Section 17 sought by SIPC is entirely consistent with the historical enforcement of the 1934 Act through judicial recognition of implied remedies thereunder.

In refusing to recognize an implied right of action under Section 17 in SIPC's favor, either in its own right or as the subrogee of Weis' customers, the District Court stated: "It should be noted that when Congress wanted to create private causes of action for violations of provisions of the 1934 Act, it knew how to do it and did do it" (A 403a). However, the District Court overlooked the fact that over the past four decades *the courts have repeatedly found implied private rights of action under various sections of*

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* See, C. Meyer, *The Law of Stockbrokers and Stock Exchanges,* §8, at 86 (1931). All or nearly all broker-dealers were partnerships. *Id.,* §19, at 133.

the securities laws as a means of enforcing those laws. The most familiar example is, of course, Section 10(b) of the 1934 Act. And the now celebrated decision upholding implied rights of action under the 1934 Act is *J.I. Case* v. *Borak*, 377 U.S. 428 (1964), which will be discussed below. But the case law is replete with decisions implying remedies under the federal securities statutes.

A convenient summary was set forth by the court in *Franklin Nat. Bank* v. *L.B. Meadows & Co.*, 318 F.Supp. 1339, 1341-42 (E.D.N.Y. 1970), in comparing the few remedies expressed by the statute to the many which have been implied by the courts:

> "Only few sections of the various Securities Acts provide explicitly for private actions. See, e.g., 15 U.S.C. §§77k, 77l, 77o (1933 Act); 15 U.S.C. §§78i(e), 78p(b), 78r, 78t (1934 Act); 15 U.S.C. §77www (1939 Trust Indenture Act); cf. 15 U.S.C. §§78cc (1934 Act); 15 U.S.C. §§80a-46, 80b-15 (1940 Investment Company Act) (makes contracts in violation of various provisions voidable). Nevertheless, courts have implied the existence of private remedies for violation of other provisions. *J. I. Case Company* v. *Borak*, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964) (15 U.S.C. §78n(a)); *Jordan Building Corp.* v. *Doyle, O'Connor & Co.*, 401 F.2d 47 (7th Cir. 1968) (15 U.S.C. §78j(b) and rule 10b-5); *Mutual Shares Corp.* v. *Genesco, Inc.*, 385 F.2d 540, 543 (2d Cir. 1967) (same); *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 787 (2d Cir. 1951) (same); *Kardon* v. *National Gypsum Co.*, 69 F.Supp. 512, 513 (E.D. Pa. 1946) (same); *Taussig* v. *Wellington Fund, Inc.*, 313 F.2d 472, 475-476 (3d Cir. 1963), *cert. denied*, 374 U.S. 806, 83 S.Ct. 1693, 10 L.Ed.2d 1031 (1963) (15 U.S.C. §80a-34(d)); *Baird* v. *Franklin*, 141 F.2d 238, 244-245 (2d Cir.), *cert. denied*, 323 U.S. 737, 65 S.Ct. 38, 89 L.Ed. 591 (1944) (15 U.S.C. §78f(b)), cited with approval in *Goldstein* v. *Groes-*

> *beck,* 142 F.2d 422, 427 (2d Cir.), *cert. denied,* 323 U.S. 737, 65 S.Ct. 36, 89 L.Ed. 590 (1944); *Goodman* v. *H. Hentz & Co.,* 265 F.Supp. 440, 445 (N.D. Ill. 1967) (15 U.S.C. §78o(b)(5)(E)); *Brown* v. *Bullock,* 194 F.Supp. 207, 223-230 (S.D.N.Y. 1961), aff'd, 294 F.2d 415 (2d Cir. 1961) (15 U.S.C. §80a-36); *Osborne* v. *Mallory,* 86 F.Supp. 869, 879 (S.D.N.Y. 1949) (15 U.S.C. §77g); *Remar* v. *Clayton Securities Corp.,* 81 F.Supp. 1014, 1017 (D. Mass.) (15 U.S.C. §78g). See also *Maher* v. *J. R. Williston & Beane, Inc.,* 280 F.Supp. 133, 137 (S.D.N.Y. 1967) (15 U.S.C. §78o(c)(1) based action barred by statute of limitations, but court assumes existence of cause of action); *Opper* v. *Hancock Securities Corp.,* 250 F. Supp. 668, 673-674 (S.D.N.Y.), aff'd 367 F.2d 157 (2d Cir. 1966) (assuming validity of cause of action based on 15 U.S.C. §78o(c)(1)); *Geismar* v. *Bond & Goodwin, Inc.,* 40 F.Supp. 876 (S.D.N.Y. 1941) (implying a money damages remedy under 15 U.S.C. §78cc(b), which makes contracts violative of 15 U.S.C. §78o(c)(1) voidable). Once a private remedy is implied, jurisdiction is based upon §27 of the 1934 Securities Act. 15 U.S.C. §78aa."

Thus, as a leading authority on the securities laws has observed, ". . . [t]he specific liabilities created by §§ 9(e) and 18 do not cover all the variegated activities with which [the 1934] Act is concerned". III. L. Loss, *Securities Regulation* 1785 (2d ed. 1961).

As the above summary demonstrates, *the federal securities laws, because of their very nature, must rely upon the implication of private remedies for effective enforcement.* Indeed, Section 28(a) of the 1934 Act states:

> "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity. . . ."

By this provision, Congress, *inter alia,* recognized that rights and remedies may arise under the 1934 Act without being explicitly set forth therein.

In addition, Section 27 of the 1934 Act specifically grants exclusive jurisdiction to the district courts of "all suits in equity and actions at law brought to enforce *any liability or duty created by this title or the rules and regulations thereunder*" (emphasis added). And, of course, the existence of private remedies under the 1934 Act "is supported by the statutory tort theory which implies 'a private right of action for a violation of a statutory duty or a liability' ". *Franklin Nat. Bank* v. *L.B. Meadows & Co., supra* at 1342. It is no longer questioned that "[t]he statutory tort doctrine . . . is now an accepted part of American law". II. L. Loss, *Securities Regulation* 942 (2d ed. 1961).* Touche Ross certainly owed a duty to SIPC and to Weis' customers under Section 17, and its breach of that duty is therefore actionable under that Section.

Moreover, the repeated judicial implication of rights of action under the 1934 Act is perfectly understandable in light of the fact that *the Supreme Court has consistently referred to the entire body of securities legislation as fundamentally remedial in nature.* See, *e.g., Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972); *Superintendent of Insurance* v. *Bankers Life and Casualty Co.,* 404 U.S. 6 (1971); *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963). Accordingly, in *Glen-Arden Commodities ,Inc.* v. *Costantino,* 493 F.2d 1027, 1033 (2d Cir. 1974), this Court stated:

> "Initially we note that, as we ourselves have been repeatedly enjoined by the Supreme Court, *the federal securities laws are to be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'* " (citations omitted, emphasis added)

Unfortunately, the District Court in this case lost sight of the remedial purpose of Section 17 and chose instead

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* See also, Restatement and Restatement Second of Torts §286 (Tent. Draft. No. 4, 1959).

to construe that Section "technically and restrictively", thereby erroneously concluding that "Section 17 was designed to supply administrative guidance in the bookkeeping area and not to create any rights in anybody" (A 400a). In so doing, the District Court simply ignored the uncontrovertible fact that the efficacy of Section 17 in general and of the net capital rule in particular necessarily depends upon the enforcement of Section 17.

It is respectfully suggested that the District Court's holding placed a judicial imprimatur on tortious conduct, exposed the net capital rule to the hazard of ineffective enforcement, and transformed Section 17 into a paper tiger—all in derogation of the Congressional intent to protect the customers of broker-dealers and at the inordinate expense of the SIPC fund.

C. Both Weis' customers and SIPC were direct beneficiaries of the duties imposed upon accountants by Section 17, and neither the SEC nor the Exchange independently verified or were expected to verify the false and misleading Section 17 reports certified by Touche Ross.

An analysis of the District Court's decision reveals that it incorrectly distinguished the case at bar from *J.I. Case* v. *Borak, supra,* where the Supreme Court implied a private right of action under Section 14a of the 1934 Act, which makes it unlawful to solicit proxies through false and misleading proxy statements. The District Court noted that in *Borak* (1) plaintiff, whose proxy was solicited, was "of the class intended to be protected by the statute"; and (2) the implication of a private right of action was "a necessary supplement to [SEC] action" because the SEC did not have the time to independently examine the proxy statements filed with it (A 405a). In attempting to contrast the case at bar from *Borak,* the District Court found that (1) the Section 17 reports certified by Touche Ross "were not for the information of any 'investors' and were not sent to them but were for the

SEC, primarily for monitoring the net capital requirements of the 1934 Act"; and (2) the SEC, in examining the Section 17 reports, "does not have the time limitations applicable to the *Borak* proxy statements" because "the SEC has an inspection program similar to that of bank examinations" (A 405a-406a). The District Court erred in both areas.

In the first place, *as it makes clear on its face, Section 17 was intended "for the protection of investors", i.e.,* the customers of the broker-dealers required to file Section 17 reports. Likewise, the net capital requirements (which are enforced by means of the Section 17 reports) are monitored—in the case of Weis by the Exchange, not the SEC—for the direct benefit of those customers. And the mere fact that the Section 17 reports were not sent to Weis' customers does not negate their reliance on the system devised for their protection. Thus, just as the plaintiff in *Borak* was the intended beneficiary of the protection afforded by Congress in Section 14a, Weis' customers (SIPC's subrogors) are the intended beneficiaries of the protection afforded by Congress in Section 17.

Similarly, *SIPC itself is a direct beneficiary of the duties imposed upon accountants by Section 17.** As described earlier, SIPC—by reason of the provisions of SIPA—relies upon the Section 17 information certified by auditors in determining whether or not to initiate the liquidation of its members (see especially, Section 78eee (a) of SIPA). The flow of the Section 17 information from the broker-dealer and its auditor to SIPC, through the SEC and the appropriate self-regulatory organization (here, the Exchange), is the critical means by which steps can be taken by SIPC to either (a) avoid a SIPA

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* It must be remembered that ". . . the provisions of the [1934 Act] apply as if [SIPA] constituted an amendment to, and was included as a section of, such Act" (Section 78bbb of SIPA). Accordingly, although SIPA was enacted in 1970, it is, in effect, appended to the 1934 Act.

liquidation, or (b) effectuate a timely decision to liquidate. As the Supreme Court pointedly noted in *SIPC* v. *Barbour, supra,* at 421-422:

> "SIPC properly treats an application for the appointment of a receiver and liquidation of a brokerage firm as a last resort. It maintains an early warning system and monitors the affairs of any firm that it is given reason to believe may be in danger of failure. Its experience to date demonstrates that more often than not an endangered firm will avoid collapse by infusion of new capital or merger with a stronger firm. Even failing those alternatives, a firm may be able to liquidate under the supervision of one of the self-regulatory organizations, or the District Court, without danger of loss to customers. SIPC's policy, therefore, is to defer intervention 'until there appear(s) to be no reasonable doubt that customers would need the protection of the Act.' *SIPC 1973 Annual Report* 7 (1974). *By this policy, SIPC avoids unnecessarily engendering the costs of precipitous liquidations—the costs not only of administering the liquidation, but also of customer illiquidity and additional loss of confidence in the capital markets*—without sacrifice of any customer protection that may ultimately prove necessary." (emphasis added)

An auditor's breach of its Section 17 duties—as Touche Ross' breach illustrates best of all—results in the frustration of the above-mentioned policy of SIPC and in the consequent heavy costs to SIPC. Surely, Congress did not intend that an auditor, who creates such damage through the Section 17 reports it prepares and certifies, should escape liability to SIPC.

In the second place, the District Court erred in attempting to distinguish the case at bar from *Borak* by suggesting that here the implication of a private right of action is not a necessary supplement to SEC action because "the

SEC has an inspection program similar to that of bank examinations". The fact is that, *insofar as the Section 17 reports underlying this action are concerned (particularly Form X-17A-5), the SEC does not perform any function which is even remotely similar to that of a bank examiner.* Rather, the SEC relies on the Section 17 financial reports prepared by the broker-dealer's auditor without "double-checking" the information contained therein. A broker-dealer is required to file two types of financial statements: a "short-form" to be prepared by the broker-dealer itself and a "long-form" to be prepared by the broker-dealer's auditor (the Form X-17A-5). While both forms are filed with the Exchange, the SEC only receives the "long-form" prepared by the auditor, and the SEC examiners do not generally attempt to independently verify the information contained in that "long-form". And it is the "long-form" which caused the deception of the SEC, and hence SIPC, in this case. Thus, the District Court's "finding" that the SEC operates in a manner analogous to bank examiners with respect to the Section 17 reports was simply wrong.* It should be noted, in this regard, that the Court's "finding" was nowhere supported by the record before it or even by the briefs submitted by Touche Ross' counsel.**

Moreover, in the first instance, SIPC would have been alerted to Weis' financial difficulty by the Exchange—not

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* The District Court's error well-illustrates the impropriety of dismissing this action at the pleading stage and thereby denying SIPC the opportunity to prove the extent to which the SEC (like SIPC) relied on the Section 17 reports certified by Touche Ross.

** The Joint Appendix submitted to this Court contains the full record which was before the District Court with respect to Touche Ross' motion to dismiss, *i.e.*, the complaint, the notice of motion, all the affidavits and all the exhibits thereto. That record is devoid of any basis for concluding, as the District Court did, that the SEC functions like a bank examiner in relation to the Section 17 reports. Indeed, it is precisely because the SEC performs no such function that Touche Ross bore such a grave responsibility in certifying Weis' Section 17 reports.

the SEC—because, as previously stated, Weis was subject to the Exchange's more stringent net capital rule. *Like the SEC, the Exchange does not attempt to independently verify the information contained in the Section 17 reports,* and, accordingly, it too was deceived by Touche Ross' certification of those reports.* Consequently, SIPC was not alerted to Weis' true financial condition until a forced liquidation became inevitable.

Thus, *in the final analysis, the protection which Weis' customers and the SIPC fund would otherwise have enjoyed was thwarted by the false and misleading reports certified by Touche Ross.* Neither the SEC nor the Exchange could have prevented this unfortunate result so long as Touche Ross persisted in violating its duties under Section 17.

D. The recognition of the right of action under Section 17 sought by SIPC is necessary for the effective enforcement of that Section, for the actual deterrence of wrongdoers, and for the restoration to SIPC of the funds of which it is deprived by the misfeasance and nonfeasance of those who violate the duties they owe under Section 17 to SIPC and the customers of broker-dealers.

The District Court properly observed that "[i]n the 43 years during which the [1934 Act] has been on the books, there has been no decision whether a private right of action can be asserted for a violation of Section 17" (A 400a). However, *the Supreme Court has repeatedly reasserted the principle that a private remedy will be implied under a statute not expressly providing one where to do so is ". . . consistent with the evident legislative intent and, of course, with the effectuation of the purposes intended to be served by the Act".* See, *e.g. Cort* v. *Ash,*

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* The Exchange does attempt to verify the information contained in the "short-form" prepared by the broker-dealer itself but not the information contained in the "long-form" prepared by the broker-dealer's accountant. As noted above, it is the "long-form" (the Form X-17A-5) which caused the deception giving rise to this action.

422 U.S. 66, 68 (1975); *SIPC* v. *Barbour, supra* at 418, *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers,* 414 U.S. 453, 458 (1974).* The effectuation of the Congressional purpose underlying Section 17 and SIPA requires that an implied right of action under Section 17 be recognized here.

The grounds for the recognition which SIPC seeks can conveniently be summarized by reference to *Cort* v. *Ash, supra.* In *Cort,* the Supreme Court suggested four "relevant" factors to be considered in determining whether a right of action should be implied under a statute. Of course, the *Cort* factors must be applied in conjunction with criteria set forth in other cases, particularly *Borak* since (unlike *Cort*) it deals specifically with the implication of remedies under the 1934 Act. The *Cort* factors are:

> "First, is the plaintiff one of a class for whose especial benefit the statute was enacted, . . . that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the

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* In each of these three cases, the Supreme Court refused to recognize an implied private right of action for a season which dramatically distinguishes those cases from the one at bar: remedies to redress the assereted wrongful acts involved in each case were lodged *exclusively* and *by statute* with public officials, *i.e.,* in *Cort* with the Federal Election Commission and the Attorney General; in *Barbour* with the SEC; and in *National Railroad* with the Attorney General. In this case, of course, neither the 1934 Act nor SIPA contains such a provision. In addition, in neither *Cort* nor *National Railroad* was there a broad statutory grant of jurisdiction to the federal courts for the private redress of wrongs caused by breaches of a statutory duty intended for the benefit of a person or class of persons. The 1934 Act —to which SIPA is an amendment—contains such a provision in Section 27, and indeed, that Section is a predicate for federal jurisdiction in this case.

> legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States so that it would be inappropriate to infer a cause of action based solely on federal law?" (citations omitted) 422 U.S. at 78.

There simply can be no question that *Congress enacted Section 17 of the 1934 Act and SIPA* (which by its terms is an amendment to the 1934 Act) *for the benefit of the customers of broker-dealers.* Likewise, it is undisputable that SIPC is required by SIPA to rely upon the Section 17 reports certified by auditors in determining whether a broker-dealer is in such financial difficulty that its customers must be protected by the commencement of a liquidation proceeding or otherwise. Moreover, since SIPA essentially serves as a back-up for the net capital rule and comes into play when that rule fails to fulfill its function, it is an integral part of Congress' scheme of investor protection and, as such, is interdependent with other parts of that scheme, particularly Section 17. In short, *SIPA simply cannot function without the benefit of the information provided under Section 17 and Congress knew this to be a fact.* Thus, both Weis' customers and SIPC are members of the class for whose special benefit Section 17, as amended by SIPA, was enacted. Put another way: just as the Supreme Court recognized in *Borak* that Section 14a was adopted expressly "for the protection of investors" (377 U.S. at 432), this Court should recognize the Section 17, as enhanced by SIPA, was adopted for the protection of the customers of broker-dealers and of SIPC.

The legislative history of Section 17 contains nothing expressing or implying a congressional intent to deny a private right of action for a breach of the duties imposed by that Section. There is no indication, as there was in *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers, supra,* that Congress considered and rejected a private remedy for the violation of Section

17. See, Hearings on S.Res. 56 and S.Res. 97 before Senate Comm. on Banking and Currency, 73rd Cong. 1st Sess., at 6561-64, 6637, 6673, 6716-17, 6726, 6841, 6914, 6993, 7043-44, 7057-60, 7282, 7454-55, 7484, 7488-89, 7529, 7567 (1934); and Hearings on H.R. 7852 and H.R. 8720 before House Comm. on Interstate & Foreign Commerce, 73rd Cong. 2nd Sess., at 22, 225, 262, 537, 666, 670, 750, 804 (1934). In general, the statements at these hearings merely make a passing reference to the requirements of Section 17 or are limited to discussions of the costs of the examinations required thereby. Congress just did not raise the question of remedies under Section 17. Moreover, as noted earlier, the legislative history of Section 18 of the 1934 Act contains no indication that its express remedies were intended to apply to Section 17; to the contrary, the language, the legislative history and the clear purpose of Section 18 indicate that the remedies under that Section were intended to apply to violations of Sections of the 1934 Act *other* than Section 17.

The underlying purpose of the legislative scheme of the 1934 Act in general and Section 17 in particular is to protect the customers of broker-dealers and, hence, SIPC's subrogors in this case. SIPA enhances that purpose and obviously extends the protection of Section 17 to SIPC. In light of *Borak* and the scores of other cases implying remedies under the 1934 Act, and given the exposition herein under Point I, it cannot seriously be doubted that the implication of the right of action under Section 17 sought by SIPC is fully consistent with the underlying purposes of the legislative scheme.

Finally, a state court could not afford to SIPC the relief it seeks under its Section 17 claims. *Since Section 27 of the 1934 Act gives the federal district courts "exclusive jurisdiction" of violations of that Act and the rules thereunder, it would be impossible for a state court to consider the action dismissed below.* Indeed, even assuming, *arguendo,* that the federal courts were not vested with exclusive jurisdiction, the reasoning of the Supreme Court

in *Borak* precludes any view that a claim under the 1934 Act is one traditionally relegated to state law. There, the Supreme Court considered but rejected relegating the Section 14 claim to the state court, stating:

> ". . . [I]f the law of the State happened to attach no responsibility to [the particular violation of the 1934 Act], the whole purpose of the section might be frustrated. Furthermore, the hurdles which the victim might face (such as separate suits, . . . security for expenses statutes, bringing in all parties necessary for complete relief, *etc.*) might well prove insufferable to effective relief." 377 U.S. at 435.

In *Cort,* the Supreme Court noted that ". . . the statute involved [in *Borak*] was clearly an intrusion of federal law into the internal affairs of corporations: to the extent that state law differed or impeded suit, the Congressional intent could be compromised in state-created causes of action" (422 U.S. at 85). This action should no more be relegated to state court than *Borak* was.

Thus, the criteria specified in *Borak* and *Cort* all unavoidably point to the conclusion that SIPC may assert a right of action, in its own right and as subrogee, for the damages it sustained as a direct result of Touche Ross' violation of its Section 17 duties.

There remains only to consider the District Court's rather unrealistic suggestion that it is not necessary to enforce Section 17 by private actions because "criminal prosecutions and SEC injunctive actions seem abundantly sufficient" (A 406a). The indictment of the Weis Five and the injunctive relief obtained by the SEC against them can hardly restore fourteen million dollars to the SIPC fund. Likewise, any criminal prosecution of or SEC action against Touche Ross would not make SIPC whole. And, as this Court knows all too well, there had been a plethora of criminal prosecutions and SEC injunctive actions arising under the securities laws for decades prior to Touche Ross' 1972 audit of Weis. Nonetheless, Touche Ross was not deterred from preparing and certifying

Weis' false and misleading Section 17 reports. *Should this Court uphold the District Court's transformation of Section 17 into a paper tiger, Touche Ross and other accountants might not be deterred the next time they improperly prepare and certify the financial reports which, as they are well aware, form the cornerstone upon which the legislative and regulatory scheme for effective investor protection rests.*

CONCLUSION

SIPC respectfully submits that the District Court's order and judgment should be reversed, and urges that this Court recognize a right of action under Section 17 in the limited and extraordinary factual context of this case—where an auditor actually facilitated the collapse of a brokerage firm and thereby caused damage to SIPC. Such a recognition would possess only therapeutic virtues and would not open the floodgates of litigation to indeterminate plaintiffs. So long as a broker-dealer complies with the financial responsibility rules to which it is subject, its auditors could frolic with abandon in the murky surf of grossly unacceptable accounting practices. It is only when the frolic deceives SIPC and the broker-dealer's customers into assuming that the broker-dealer is financially sound, where in fact it is not, and results in the inevitable liquidation of the broker-dealer, that the rule of law urged herein would apply.

Respectfully submitted,

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Edward S. Reddington, as Trustee for the Liquidation of the business of Weis Securities, Inc., and Securities Investor Protection Corporation,

Plaintiffs-Appellants

against

Touche Ross & Co.

Defendant-Appellee

AFFIDAVIT OF SERVICE

STATE OF NEW YORK,
COUNTY OF New York , ss:
Raymond J. Braddick,

being duly sworn,

deposes and says that he is over the age of 21 years and resides at 11 Park Place New York, New York

That on the 13th. day of July 1977 at

he served the annexed Brief of Plaintiff-Appellant S.I.P.C. upon

Hughes Hubbard & Reed Esqs.
Attorneys for Plaintiff-Appellant
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in this action, by delivering to and leaving with said attorneys

five ~~xxxxx~~ true copies to each thereof.

DEPONENT FURTHER SAYS, that he knew the persons so served as aforesaid to be the persons mentioned and described in the said action.

Deponent is not a party to the action.

Sworn to before me, this 13th.
day of July, 1977

Raymond J. Braddick

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4509705
Qualified in Delaware County